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## **Ch 11 Governing in times of austerity**

Deborah Mabbett (Birkbeck)

In 2015, as the general election was being fought, a drama unfolded in the euro area. Greek voters rejected austerity imposed by the country's creditors, and debt default and euro exit looked likely. Critics argued that austerity had crippled the Greek economy, and indeed slowed the recovery of the euro area as a whole. Policy-makers in Northern Europe, particularly in Germany, were said to be in the grip of the 'dangerous idea' (Blyth 2013) that the norms of good housekeeping should be the basis of economic management, and that governments should therefore not spend more than they raised in revenue, regardless of the condition of the wider economy.

The tenor of the debate about austerity in the UK presents a striking contrast. Policymakers might have believed for a time that austerity was necessary to satisfy creditors, but any threat of a government bond crisis quickly faded after 2010. Austerity was a policy choice, made by the Conservatives, supported by the Liberal Democrats, and not categorically opposed by Labour. The 2015 election result suggests that it was not devastatingly unpopular. This chapter considers several possible explanations of why this was. One is that austerity has not actually taken place: for all the talk, the really damaging cuts to public expenditure have yet to come. This claim is largely rejected on the basis of the evidence presented below, but the government did soften the blow of cuts in public expenditure by also cutting taxes. This suggests a second explanation: that 'austerity' in the UK has been more about shrinking the state than balancing the budget, and has therefore been popular with some political constituencies. In so far as austerity did mean hardship, this was not distributed over the whole population: on the contrary, austerity was accompanied by increased inequality. Complementing this is a third distinctive aspect of the UK's austerity: that while it might initially have slowed the country's recovery from the financial crisis and induced a 'double dip' depression, the economy did begin to recover in time for the election, while much of the euro area economy languished.

In the following discussion, I consider first whether austerity would have been forced on any government by the parlous condition of the government finances in 2010, and explain the differences between Labour's fiscal plans and those of the Coalition. I then review the government's choice of targets for cutting spending. After documenting the effect of austerity on public services and living standards, I come to the question of why austerity was apparently so difficult for the Opposition to oppose effectively. Before the election, Nicola Sturgeon of the Scottish National Party gave the country a brief masterclass in how the dominant narrative of austerity might be challenged, but the Conservatives responded vigorously by portraying a possible Labour-SNP coalition as incompetent to govern. This was 'statecraft' (Gamble 2015): instead of reacting to public opinion, Conservative politicians were proactive and strategic in defining their programme. Austerity worked as a policy that portrayed the Conservative party as uniquely competent to govern, thereby attracting sufficient voter support for victory in the 2015 election.

Finally, I turn to the relationship between austerity and growth. While persuading the public that austerity is competent is made easier by the apparent common sense of balancing the books, it is made harder by the negative effect of austerity on the economy. If public expenditure cuts dampen growth in the economy, one effect is that tax revenue falls, the deficit does not fall and the debt burden continues to rise (see Box 11.1). These ‘Keynesian’ effects of austerity on the economy are one of the main reasons why, for all the government’s expenditure-cutting efforts, the target of eliminating the deficit by 2015 was not met. The new target for a surplus by 2020 will not be met either, unless there is a sustained upturn in economic growth.

The budget presented by the Chancellor contains projections for revenue and the deficit that depend on forecasts of growth. A positive growth forecast will make the government’s financial plans look better than a gloomy prognosis for the economy. Since 2010, a specialised independent body, the Office for Budget Responsibility (OBR), checks the growth forecasts used in the budget. In the final section on growth, fiscal rules and fiscal monitoring, I discuss the possible effects of the OBR’s oversight of the government’s claims and promises about the budget.

One reason for the public to accept the pain of austerity is that it might help to put the UK on a more sustainable growth path than that taken in the 2000s, which ended with the disaster of the financial crisis. But, in the final section, I argue that the effect could be exactly the opposite: restrictive fiscal policy means a heavy reliance on monetary policy to stimulate the economy, and that may result in new asset price bubbles and set the economy up for a reprise of the instability of the late 2000s.

### **Austerity and the bond markets**

The 2010 election took place in exceptionally bad fiscal conditions. The financial crisis had contributed to a large fall in tax revenue, and the previous government had also increased its own spending to counteract the crisis-induced fall in private consumption and investment. The result was that the government’s deficit had increased to some 11% of GDP in 2009-10. In turn this meant that debt was mounting every year, reaching nearly 53% of GDP by 2009 even with financial rescue measures excluded (Budget 2011, Table 1.3: 24). The Conservatives fought the election promising to tackle ‘Labour’s debt crisis’. The Liberal Democrats joined the Coalition embracing essentially the same analysis of the urgency of ‘acting now on debt’. In the last budget of the Labour government in March 2010, Alastair Darling announced a long-term plan for restoring the public accounts to balance. The new Chancellor, George Osborne, brought in an ‘emergency’ budget in June 2010 which preserved Labour’s plans but added substantial immediate cuts, particularly in funding for local government, along with longer-term plans to bring down social security spending. The more popular spending areas of health and schools were protected, but the axe fell heavily on some areas traditionally favoured by the Conservatives, such as defence and policing.

Why did the main parties disagree about the timing of retrenchment? The Conservatives cultivated the idea that there was an urgent need to take steps to reassure financial markets: a claim which apparently helped to convince the Liberal Democrats that they

should join the Coalition for the sake of the country (Gamble 2015: 46). In mid-2010 the Euro area was in the midst of a government bond crisis (see Box 11.1). In May 2010, as the country went to the polls, the interest rate on UK government debt was less than 1% higher than the rate on German government debt, the lowest in Europe. This did not prevent mounting anxiety about the prospect of the bond market crisis spreading to the UK. With the benefit of hindsight, these fears seem overblown, because the Bank of England could step in and buy gilts. Since 2010 it has done this on a large scale, not to rescue the government but as part of the expansionary monetary policy technique known as ‘quantitative easing’. But in 2010 quantitative easing was in its infancy, and few would have forecast that interest rates would remain low for years.

**Box 11.1: The language of austerity**

Austerity is implemented through *fiscal policy*, which refers to the government’s decisions about the spending it undertakes and the taxes it sets. The difference between spending and revenue is the *fiscal (or budget) deficit*. To pay for spending that is not covered by tax revenue, the government borrows an amount equal to the deficit, which increases its stock of *debt*. Borrowing is done by selling government bonds, known as *gilts* in the UK, to savers and institutions that manage savings, such as pension funds. Normally, the interest rate or *yield* that the government has to pay on gilts is lower than the rate that other borrowers (firms or households) have to pay, because gilts are regarded as ‘safe’: the government will always repay its debts (mainly by issuing new debt). However, if buyers lose confidence that the government will repay, the interest rate they demand will go up. When the interest rate is greatly in excess of the economic growth rate, the government’s finances rapidly get into a worse and worse state. Bond buyers know this, and demand an even higher interest rate, provoking a *government (or sovereign) debt crisis*.

The government can raise taxes and cut expenditure to reduce the deficit. However, higher taxes and lower spending will reduce demand in the economy, causing lower growth or even an economic contraction (negative growth). This *Keynesian effect* of fiscal policy on the economy can be offset by an expansionary *monetary policy*. Monetary policy is controlled by the Bank of England, and refers to the decisions it makes about interest rates and other measures to promote or suppress borrowing and spending by firms and households.

The Labour opposition argued that premature austerity damaged the recovery from the financial crisis. A slight recovery was underway by the time of the election, but this ended and the economy entered a ‘double-dip’ recession. By January 2011, there was already much talk in the business press of the need for a ‘Plan B’ that would promote growth. By the end of 2012, the Chancellor had to admit that, because growth was lower than expected (and tax receipts therefore depressed), the plan to eliminate the deficit by 2015 would not be met. One consequence was that the UK lost its triple-A credit rating early in 2013. In normal times, this would have damaged the government’s finances further by pushing up the yields demanded by bond buyers. This did not happen, because there was nowhere else for buyers to turn: many major economies were experiencing similar downgrades.

In the face of these pressures, the Coalition insisted that it would stay the course in restraining public spending, but it did create some stimulus via tax cuts. In the 2011 budget, the Chancellor began a staged reduction in corporation tax, from 28% to 26% in 2011, with further steps down to reach a rate of 20% in 2015. From the first budget in June 2010, the government also began the implementation of the central Liberal Democratic policy of raising the personal tax allowance, taking more low-paid workers out of the tax system. The headline figure of a £10,000 allowance was reached in 2014.

Thus austerity took on a distinctive shape, with the focus on cutting expenditure rather than raising revenue. Projections to the end of the decade show that more than 90% of the reduction in the deficit will come from expenditure reductions, and less than 10% from tax increases (OBR 2014: 17). This strong expenditure-reduction bias in the government's approach is indirect evidence that austerity has been more about seizing the opportunity to reduce the size of the public sector than addressing a pressing financial threat.

### **How much austerity has there been?**

The last Labour budget in March 2010 set out plans to restore budget balance in ten years. Labour proposed some £21b in tax increases and £51b in expenditure reductions (Crawford 2010). Soon after the election, the Coalition produced an emergency budget which shortened the time horizon for eliminating the deficit to five years (the term of the Parliament). This target was not achieved, despite the announcement of dramatic additional expenditure cuts. There are two main reasons why the deficit might not come down as planned. First, the plans may not be implemented, so that actual expenditure is higher than anticipated. Second, if expenditure cuts depress the economy, they will also reduce tax revenue, so the gap between expenditure and revenue does not close.

#### *Planned and actual expenditure cuts*

Cuts were not applied uniformly across all areas of government spending. Real-terms spending on health and schools was 'ring-fenced'. Some spending is not at the government's discretion, such as interest payments on debt. Social security spending cannot simply be cut in cash terms by announcement. The amount the government spends is determined by legally-binding rules. Those who meet the legal conditions are entitled to benefits, and cannot just be told that the money has run out. Cuts have been implemented in social security by changing the rules, in the expectation that the new rules will disqualify people or reduce their entitlements, but sometimes these expectations are confounded. If the economy does not perform as hoped, or people do not get the jobs that are forecast, or rents go up more than expected, then savings are not realised.

One effect of these constraints was that, in the 2010-15 Parliament, cuts were concentrated in departments where spending is subject to 'departmental expenditure limits', meaning that it is set in cash terms. Heavily affected were policing, defence, environmental protection, central government administration and grants to local government. In the 2015-20 Parliament, the rate of cutbacks in these areas will slow down, and there is heightened attention to social security spending. The government has

created a cash limit called the ‘welfare cap’ to indicate its target of reducing spending on benefits other than old age pensions. Table 11.1 shows how the composition of government spending is projected to change further in the coming five years. The projections are subject to considerable uncertainty. Strikingly, the share of government spending on debt interest went down between 2010 and 2015, despite rising government debt, because interest rates were low. The amount is projected to rise, but there will be savings on interest payments if rates stay low for an extended period.

**Table 11.1**

**The changing composition of government expenditure**

% current expenditure

	2010-11	2015-16	2020-21
Health	15.0	16.6	*
Education	7.9	8.0	*
Total spending subject to departmental expenditure limits	51.7	46.7	45.1
Social security benefits and tax credits	30.7	32.1	29.7
of which - not subject to welfare cap (mainly old age pensions)		14.3	14.7
Interest on government debt	6.8	5.1	7.1

\* The allocation of departmental spending to 2020 had not yet been announced at time of writing. Sources: OBR 2011: Table 4.15; OBR 2015: Table 4.13 and Chart 4.9

There was some, but limited, scope to cut social security spending in politically-popular ways. The government tapped into resentment by working people of others who received their living from the state. This was cultivated by the policy of imposing a ‘benefit cap’ which limited the total amount that a household could receive in benefits relative to the average wage, drawing attention to the position of some benefit recipients relative to working people. This was largely a symbolic policy: it saved a mere £330m a year (see Table 11.2). Less symbolic, but also apparently politically acceptable, was the ‘affluence testing’ of child benefits, which are now not paid to households containing a higher-rate taxpayer.

The bulk of savings in social security spending were achieved through methods that did not attract public attention. Cuts in the level of benefits would be very noticeable if done in money terms, but benefits can be eroded with low visibility by failing to index them fully to inflation. In the June 2010 budget, the Chancellor announced that the index used to adjust benefits would be changed to one that tends to produce lower increases. Furthermore, some benefits were frozen for three years, including child benefit. In the 2012 Autumn statement, the Chancellor turned to indexation again to achieve further savings, announcing that benefit increases (other than old age pensions) would be capped at 1% per annum for three years. All in all, freezes and caps on indexation had a much bigger effect on the social security budget than all other measures combined.

**Table 11.2 Planned cuts in social security in the 2010-15 Parliament**

	Projected annual saving in 2014-15 in £s million
Indexation changes (2010)	5840
Freeze in child benefit	975
1% uprating (2012)	2175
Benefit cap	330
Reforms to incapacity benefits and Disability Living Allowance	2885
Child benefit cut for higher-rate taxpayers	2445
Tax credit reforms	3220

Sources: Table 2.1 of successive budgets and autumn statements

The government hoped to achieve reductions in expenditure on disability benefits by conducting a programme of reassessments, identifying those who could be working rather than relying on benefits. But many of those who were ruled capable of work in reassessments appealed successfully against these judgments, the process attracted public criticism, and little money was saved. Here the government trod in the footsteps of previous governments, both Labour and Conservative, who had thought they could identify ‘shirkers’ by reforming assessments. These policies have never succeeded in producing significant and sustained reductions in the growth of benefit expenditure. Thanks to the creation of the OBR, there is now much clearer evidence than there used to be of how projected savings may fail to materialise. In 2011, the government planned to save about £2.9b a year in disability-related expenditure by 2014 (as shown in Table 11.2). By 2013, the expected saving had fallen to less than £2b. In 2014, the figures were revised again: in place of savings, the projections show a slight but steady growth in expenditure (OBR 2014b: Chart 4.5).

Looking for savings after the 2015 election, the government’s eye alighted on tax credits. These are benefits (or ‘negative taxes’) paid to people who are working, whose earned income is inadequate for their family’s needs. As Table 11.2 shows, there were substantial cuts to tax credits in the 2010-15 Parliament, achieved through numerous small adjustments to the various thresholds that calibrate the system. These cuts were opposed by Labour, but it was unable to rally a wider movement against them. However, when the government proposed further cuts to tax credits after the 2015 election, the House of Lords rejected the enabling regulation. If the welfare cap is to be complied with, cuts will have to be found elsewhere.

### *Planned and actual revenue*

Government revenue depends on the state of the economy: thus the double-dip recession in 2011-12 reduced tax receipts. Furthermore, as economic growth has resumed, tax receipts have not kept pace, and the tax-to-GDP ratio has fallen. Only part of this is due to policy changes, such as the increase in income tax personal allowances. Striking examples of other changes include declining revenue from tobacco duties, as the tax base (spending on cigarettes) has fallen due to the decline in smoking. Another tax 'underperformer' has been Stamp Duty paid on house sales: although house prices have recovered, transaction volumes have stayed low. But perhaps the most important and profound source of revenue shortfall has been income tax, because wages and salaries have declined as a share of GDP.

There is not much the government can do to stimulate growth in those parts of the economy that produce the most tax revenue. Obviously, it does not want people to start smoking more, or even drinking more – spending on alcohol has also declined relative to the size of the economy (OBR 2014a: 109). It has tried to increase transactions in the housing market with a scheme to help first-time buyers. Perhaps its most audacious move to improve revenue has been the increase in the minimum wage announced in the new Conservative government's summer 2015 budget. The fiscal effects of higher wages are expected to be positive if small: the OBR (2015: 98) predicts an increase of £0.1 billion in income tax and national insurance by 2020.

In summary, has austerity really happened? The basic answer is surely yes: there have been substantial direct cuts in expenditure. The three reasons to modify the answer are that there have been tax giveaways too, that not all planned expenditure cuts have happened, and that the deficit has not come down as forecast because of slow growth, particularly in some economic activities which have a strong effect on tax revenue.

### **The impact of austerity on public services and living standards**

Given that the government's deficit has not fallen as planned, it is tempting to conclude that austerity has not been as bad as all that. But the size of cuts in expenditure can understate the real impact of austerity on public services. Cuts in services can take place even when spending is constant, if demand for services is rising. Thus the real-terms protection of the NHS budget will not ensure the maintenance of services, given the increasing needs of a rising and aging population. Hidden cuts in services are also occurring in schools, where the government committed itself to maintaining spending. The number of school children is going up, so stable expenditure means a decline in per-pupil spending. The impact on many schools was heightened by the introduction of a flagship Liberal Democratic policy, the pupil premium. This policy means that schools with the most disadvantaged pupils get more money, but this leaves less for other schools (Crawford 2010).

As well as being partly hidden in this way, the impact of austerity has also been highly unequal. A number of studies have sought to establish how austerity has affected the distribution of income and welfare in the UK. The most straightforward results are from



studies of the effect of tax and social security changes on households across the income distribution. Using the technique of ‘microsimulation’, researchers take models which include a representative sample of UK households, and apply the tax and benefit changes to their income and circumstances.

An authoritative study of the impact of austerity using microsimulation highlighted two striking conclusions (De Agostini et al 2014). First, direct tax and benefit changes since May 2010 did not contribute to deficit reduction. The measures were fiscally neutral because reductions in benefits and tax credits have been ‘spent’ on raising the personal income tax allowance. Second, people in the bottom half of the income distribution lost out overall, while those in the top half of the distribution gained. This seems surprising as it might be assumed that poorer households would gain from the tax allowance as much as they lost from the benefit changes. Certainly the Liberal Democrats aimed to present themselves as the tax-cutting party for the low-paid with their focus on raising the personal allowance. However, higher tax allowances do not benefit those who earn too little to take advantage of them, and they bring the biggest benefits to two-earner households in the middle of the income distribution, as each earner can claim an allowance. Lone parents, with only one tax allowance, are among the major losers.

Analyses such as this focus on austerity in the government budget, which has an effect on households when services and benefits are cut and public sector employees lose their jobs. Households are also affected by austerity in other ways. As the economic downturn has continued, many households have been affected by unemployment, underemployment (having to take part-time instead of full-time work, or obtaining only intermittent work) and declines in real wages. While it is possible to get a general sense of the magnitude of these changes from statistics on wages and prices, studies of their impact have to piece together an account based on indicators such as the expanding use of food banks and reports from schools about the welfare of children, or they rely on interviews (Clark 2014). Some accounts are policy-oriented, focusing on the spread of practices which disadvantage poor households such as delays in paying social security benefits (All-Party Parliamentary Inquiry into Hunger in the UK 2014).

While these studies give a picture of how austerity affects the poorest, it is less often noticed that some households have benefited from the characteristic policy mix of this period of austerity: specifically from very lax monetary policies. For example, those with ‘tracker’ mortgages gained from lower mortgage interest rates, while holders of financial assets benefited from central bank measures to support the economy. Efforts have been made to calculate the effects of monetary policy on inequality. There has been a particular focus on the effects of quantitative easing (QE) which works (if it works at all) by boosting the value of financial assets, which in turn is hoped to make the holders of those assets more inclined to spend or invest. Estimates by the Bank of England in 2012 suggested that QE had boosted UK households’ net financial wealth by £600b. Financial wealth is very unequally distributed: the top 5% of households have 40% of the financial assets of the household sector (Bank of England 2012: 11). This means that the direct benefits of QE were also very unequally distributed. Ben Chu of the Independent updated the Bank’s figures and calculated that the top 10% of households benefited from QE to

the tune of nearly £350,000 each (Chu 2012). While this is a very approximate calculation, it is consistent with the Bank's own methodology.

These estimates suggest that austerity has had very differentiated effects on the population, with a pronounced pattern of public poverty and private wealth. Since private wealth is very concentrated, while poorer households rely more heavily on public services, the overall impact of austerity has undoubtedly been to magnify inequality. One might expect that this would have political implications. Gains for a small minority and losses for a large group would normally be a recipe for political disaster in a democracy, but this was not the case.

### **The political consequences of austerity**

Mark Blyth (2013) has provided a critique of austerity, arguing that it is not necessary and does not work. Why, then, do governments embrace austere policies? Blyth never really answers this question. He focuses on the prescriptions of economists, tacitly assuming that politicians are heavily influenced by economic arguments and prone to conclude that 'there is no alternative'. This analysis might be persuasive in the study of austerity in heavily-indebted countries that rely on international lenders for support, although even then it fails to explain why the lenders are so enamoured of evidently counter-productive policies. His account explains very little about the UK, where it has been clear that the government has had choices about the timing of fiscal retrenchment and the balance between expenditure reductions and tax increases.

Andrew Gamble (2015) takes a different approach to explaining the attractions of austerity, specifically in the context of the UK. He sees austerity as a strategy to win and hold office. Its key feature in the context of the 2010 election was that it enabled the Conservatives to blame Labour for the economic crisis, claiming that they had persistently overspent during the 2000s and were now in denial about the extent of the reversal that was required. Any attempt by Labour to rebut this argument and point to the role of the financial crisis in causing the deterioration of public finances could be portrayed as self-serving and delusional. Labour had proven itself incompetent to manage the economy; only the Conservatives had the courage to take the necessary steps to restore health and balance.

Gamble frames his analysis with the concept of 'statecraft'. This concept draws attention to the strategic choices governments make in defining their political agenda. Their central problem is to maintain their distinctive partisan identity, and thereby satisfy their core supporters, while pursuing sufficiently centrist policies to win future elections. A party that wins power and then concentrates on providing payoffs to its core voters can expect to be punished at the next election: in this sense, the UK does not have 'winner-take-all' politics, despite the lack of formal limits to the powers of the winning party in government. The statecraft of austerity worked by satisfying centrist or swing voters that the policy was competent, while also offering to the Conservative heartland the prospect of a smaller state and tax cuts.

### *Competence and partisanship*

Gamble's account helps to explain why Labour had great difficulty in putting forward opposing arguments. They accepted much of the austerity agenda, ending up arguing over details about scale and timing. But austerity is also risky for the Conservatives, particularly because of its predictable effect in dampening growth. The claim that austerity was a responsible policy would lose its attraction if the economy went into a sustained decline. Ipsos-MORI's regular polls asking which party is best at managing the economy found that the Conservatives overtook Labour in 2008 and held their lead (sometimes fractionally) right through into 2014. There was a pronounced upturn in approval between March and October 2010, suggesting that the emergency budget was well-received (Ipsos-MORI n.d.a), and there was also a very strong positive verdict for George Osborne in June 2010 (61%; net outcome +32). However, this faded as economic optimism declined. The Coalition's rating for economic management in October 2011 was poor: just 36% said it had done a good job compared with 55% assessing it as bad, a net score of -19 (Ipsos-MORI n.d.b).

Using data for the period 2004-2013, Whiteley et al (2015) assessed how each government's rating for economic management correlated with political support, measured by voting intentions. They found that there had been a strong relationship during Labour's term of office but, at the time they did their analysis, the Coalition did not appear to be benefiting from the nascent improvement in the economy. Assessments of economic management were slow to shift: while economic growth was restored in 2013, the government's net score did not scrape into positive territory (+1) until March 2014. Whiteley et al (2015: 22) suggest that the government was not reaping political rewards because the recovery had 'not reached the wallets and purses of the average voter'. However, by 2015, the government's ratings had picked up strongly: in March 2015, the net score stood at a healthy +19% (Ipsos-MORI n.d.b).

Was economic growth the key to winning the 2015 election? The perspective of 'valence' politics suggests that it was. The (reasonable) assumption is that all voters want a thriving economy, and their decision about which party to support is based on their assessment of which will be most competent at delivering that outcome. But, as shown above, austerity also had pronounced distributional effects, suggesting that there might be some role for a spatial analysis of voter preferences. A simple spatial model supposes that voters have different redistributive preferences related to their income. To the low-income left of the spectrum, voters favour redistribution; on the high-income right, they seek tax and expenditure cuts.

There is a reason to think that there is a right-wing, small state bias in the UK's first-past-the-post electoral system that the Conservatives have managed (yet again) to exploit. The reasoning runs as follows. The electoral system means that two main parties dominate the political contest, one centre-left and the other centre-right. Each tries to appeal to the median voter, but faces a problem of commitment: can it be trusted to maintain a centrist policy once in office? The centre-left party in office may pander to its core constituency by adopting strongly redistributive policies that are costly to the median voter. The right-wing party may also have a bias, towards cutting back benefits and services that are not

favoured by its core constituency but are valuable to the median voter. The key argument is that the costs of the right-wing bias are likely to be seen by the median voter as smaller than the costs of the left-wing bias. A right-wing bias means a smaller state and lower benefits and services, but it also means lower taxes. It means a system where you 'keep what you earn' whereas the left-wing party holds out the galling prospect of paying taxes with the proceeds going to other people (Iversen and Soskice 2006).

The logic of this analysis is not watertight. It assumes that the right-wing party does not engage in regressive redistribution, taking from the middle and giving to its wealthier core constituents. It also neglects other policies than taxing and spending, where the right-wing government may be drawn into measures that those in the middle see as costly, such as leaving the European Union. Nonetheless, it suggests that there are political gains to be had from a fiscally conservative policy that go beyond establishing a reputation for economic competence.

#### *Locking-in austerity?*

'Small state' politics and distrust of government spending may have self-reinforcing elements. As the government becomes less well-funded, the services it provides fall in quality, and more people turn to private alternatives. Haffert and Mehrrens (2015) present a study of countries that experienced severe fiscal crises in the 1980s or 1990s, imposed austerity, and gradually worked their way to positions of budget surplus and debt reduction. They show that the fiscal space thereby created was not used to revitalise public services; instead, an austere approach to expenditure was maintained, and the fruits of fiscal improvement were disbursed in tax reductions. They suggest that austerity has a number of 'lock-in' effects which mean that the size and capacity of the government is permanently reduced. Expenditure reduction becomes an obsession, pursued to the exclusion of other goals. Politicians who have invested political capital in making the case for austerity do not want to risk their reputations for responsible fiscal guardianship by changing course. Radical reforms to some public services lead to the development of alternative private provision, and political constituencies shift to support these changes.

The experience of Conservative governments between 1979 and 1997 suggests that these 'path dependent' processes have some power, but also some limitations. Not all public spending is unpopular with voters on the right, and there is little evidence that demand for public services has fallen with private purchasing filling the space. While privatisation of funding is well underway in higher education, middle class resistance is high in other potential areas such as care services provision. The policies advocated by the Conservatives' right-wing competitor, UKIP, do not indicate that the ground of public service provision has shifted radically. In the 2015 election, UKIP focused on the government's failure to meet its deficit and debt reduction targets, but it also drew attention to pressure on public services, although it attributed this to immigration rather than underspending.

Towards the end of the Coalition's term in office, senior Liberal Democrats sought to put some clear water between their party and the Conservatives. One of their criticisms was

that the latter's embrace of austerity was 'ideological', implying that it went beyond what was necessary for sustainable public finance and that it was politically extreme (see eg Alexander 2014). The discussion in this section has suggested, on the contrary, that Conservative policy was calculated for electoral advantage.

### **Growth, fiscal rules and fiscal monitoring**

The Chancellor began his term of office in 2010 by announcing an intention to eliminate the deficit by the next election. Since then, he has had to abandon this target, setting out instead a 'fiscal mandate' that requires that the government plan for balance in the future, without necessarily ever achieving it. This section addresses two questions. First, why do governments persist in announcing fiscal targets? Do they mean that future governments will be locked in to austere policies? Second, what does austerity mean for growth? Spending cuts may have played a part in the 'double dip' recession, soon after the Coalition came into office in 2010, but does austerity ultimately create the basis for more sustainable growth?

#### *Fiscal rules and the Office for Budget Responsibility*

Soon after the election in 1997, Labour announced a 'golden rule' for fiscal policy, whereby the government committed itself to maintaining a balanced budget over the course of the business cycle. Economists and political scientists have long debated the desirability and significance of such rules, bearing in mind that they are unenforceable. Lohmann (2003) argued that such commitments are the political equivalent of getting married. It is not that anything really changes in the relationship, but making a commitment in the presence of others binds the partners by raising the costs of breaking up. Fiscal rules can impose political costs if they are not complied with. This was the experience of Labour: Alastair Darling had a torrid time explaining the 2009 budget, which projected a long slow return to balance. The golden rule was junked, and the Opposition made great capital out of this, even though many economists believed that a substantial fiscal stimulus was needed to avert a depression on the scale of the 1930s.

One inference that George Osborne might have drawn is that fiscal rules are best avoided. Arguably, Labour had more reason to tie its hands with economic rules than the Conservatives. Labour was always vulnerable to the suspicion that its left wing would pull it towards an expansionary economic policy. Thus it made sense for Labour to set an inflation target and delegate the task of hitting it to the Monetary Policy Committee of the Bank of England, whereas Margaret Thatcher had resisted proposals for central bank independence as unnecessary constraints on the government's freedom to choose the most politically expedient monetary policy. The same argument would seem to apply to fiscal hands-tying.

On the other hand, it was tempting to press home criticism of Labour's economic policy by trumping the golden rule with something that looked even better. Labour had been accused of manipulating the rules by using over-optimistic growth projections. By creating the OBR in 2010, an independent body to verify and sign off growth forecasts,

the new government protected itself against such criticisms. There would, the message went, be no cheating on the rules under the Coalition.

Some observers see the OBR as tightening the constraints on the government. Berry (2013) has claimed that the OBR is an agent of austerity, which ‘institutionalises the misleading analogy favoured by Conservative politicians between the public finances and a household budget’. But this argument can be turned on its head. Labour was accused of cheating, but its forecasts, while wrong, were not unreasonable in the light of the information available at the time. It would have been better for Labour if its forecasts had been signed off by an independent body. It is beneficial to have independent verification of the government’s projections and forecasts, to safeguard it against claims of bad faith. In other words, the OBR could protect the government’s credibility if targets could not be reached.

This argument has been taken further by Wren-Lewis and Portes (2014). They suggest that governments have difficulty in providing sufficient stimulus in an economic downturn because of pressure to rein in the deficit. This pressure can come from public opinion – which might be excessively swayed by the ‘common sense’ of austerity – or it can come from the bond markets. Either way, governments need a way of avoiding immediate cuts in a downturn while setting out credible long-term plans, and fiscal institutions might provide this.

The working methods of the OBR have an inbuilt Keynesian element, in the form of cyclical adjustment. The aim is to give a ‘structural’ or medium-term view of the public finances that is not affected by booms and busts in the economy. In 2013-14, an adjustment factor of 1.6% of GDP was applied, which meant that the OBR took the view that, if the economy had not been in recession, the government would have received that amount in extra revenue or savings in benefit expenditure. The worse the OBR estimates the cyclical state of the economy to be, the larger the adjustment factor that is applied, so the adjusted fiscal figures look better than the raw data. At various points since its foundation, the OBR has been accused of applying adjustment factors that are too large, making the government’s performance look better than it really is (O’Connor 2012). These criticisms suggest that the OBR is not a hawkish agent of austerity.

#### *Austerity and sustainable growth*

One does not have to be a raging fiscal conservative to worry about whether continuing deficits and rising levels of government debt are sustainable. However, it is clear that, if austerity reduces growth, it does not improve the sustainability of the public finances. To bring about growth while the government is imposing a fiscal contraction, the Bank of England has pursued an exceptionally expansionary monetary policy. But will this lead to sustainable growth?

In the first phase of recovery from the financial crisis, there was a tantalising possibility that the UK economy would not only recover, but also ‘rebalance’. The buoyant economic conditions of the 2000s had been built on a debt-fuelled boom in household consumption. The country as a whole was a net borrower from the rest of the world, with

a small but persistent current account deficit. The crisis in the financial services sector and the depreciation of the pound in 2009-10 seemed to present an opportunity for more industrial investment and a revival of exports.

At time of writing (late 2015), this has not happened. In early 2015 the country achieved the highest current account deficit recorded since 1948, at 5.5% of GDP. Adverse external conditions – particularly the prolonged recession in the euro area – are largely to blame. But there are also concerns that austerity is delaying investment in public infrastructure that is needed for industry to thrive (LSE Growth Commission 2013). In 2015, the new Conservative government reversed tax and subsidy measures to combat climate change: a reversal that appeared to be financially-driven. These policy changes will not improve the sustainability of UK growth in the long term, and may also discourage investment in the short term (Harrabin 2015).

If the investment climate is adverse, then monetary policy can work in undesirable ways. In the UK, monetary stimulus is felt primarily through rising house prices, increased mortgage lending, and higher consumer expenditure sparked by optimism brought about by rising housing wealth. Despite the Conservatives' criticism in their 2010 manifesto of the old growth model built on debt, inflated housing equity and private consumption (Hay 2011: 24), it seems that the government is just as reliant on this channel for recovery as its predecessors.

## **Conclusion**

Gamble (2015) argued convincingly that austerity was a politically astute policy, particularly in the way it assigned blame for the after-effects of the financial crisis to the previous Labour government. However, he also saw risks for the Conservatives, as they have staked a lot of political capital on reducing the deficit. This will not occur until the end of the decade: possibly not in time for the next election. This is not something that the government can do much about. If it cuts spending more sharply, it risks strangling growth. Austerity 'effort' does not necessarily produce a good fiscal outcome.

The Conservatives' 'statecraft' of austerity blamed Labour for high debt and deficits, and suggested that it was not competent to govern. Under Miliband, Labour struggled to establish its credibility, insisting that its plans would also bring the deficit under control. One consequence was that the Opposition did not categorically oppose austerity. This changed with the election of Jeremy Corbyn to the Labour leadership in September 2015. Labour's rejection of austerity is now unequivocal. In some ways, this was a timely change. The passage of time has made the Conservatives' insistence that Labour is to blame for the deficit less convincing. Furthermore, the second round of expenditure cuts is likely to be more politically damaging than the first, as more households are affected and valued services lost. The rising tide of opposition to cuts in tax credits illustrates this.

This chapter began with the question of why austerity in the UK has not brought more open dissent and political failure for the leading party associated with it. The primary answer is that austerity has been a tailored and targeted process. It may also be self-

reinforcing. Expenditure cuts can provoke a downward spiral: voters become increasingly disillusioned with the provision of public services, and vote for a smaller and smaller state. However, there are countervailing tendencies. The UK's centralised system of government makes it easy to attribute blame. Ministers in overstretched departments fight hard for more resources, even while they may continue to assert their support for the overall policy of austerity. In the background, low growth intensifies the pressure; economic revival could ease it. The prognosis for the next five years is uncertain, but one thing is sure: political calculation, rather than ideological commitment, will determine the Conservative government's choice of policies.

### **Further reading**

The Office for Budget Responsibility (OBR) produces regular reports on the government's fiscal plans, as well as assessments of welfare trends. These reports are a good deal more informative than the Treasury's budget documents, but they tend to avoid direct criticism of the government. The Institute for Fiscal Studies (IFS) produces budget analyses that are somewhat more forthcoming in pointing out winners and losers, but they are still rather technical. The Joseph Rowntree Foundation has sponsored a programme of research on the impact of austerity, including both statistical analyses and qualitative studies. There is an abundant literature in economics on the pros and cons (mainly cons) of austerity, to which Blyth (2013) provides a readable introduction. Wolfgang Streeck (2014) has also provided a trenchant analysis of austerity in a number of developed countries, as part of a special issue which also includes several articles on fiscal rules. Andrew Gamble (2014) provides an extended account of post-crisis austerity, while Stanley (2014) complements and extends Gamble's arguments about political acceptance of, or acquiescence to, the government's policies.

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